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SENSITIVE

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TAGS: ECON EFIN CE ECONOMICS
SUBJECT: PRESIDENT PROMISES SIGNIFICANT WELFARE AND
TAX INCREASES IN 2006 BUDGET PROPOSAL

REF: (a) Colombo 1935 (b) Colombo 1853

¶1. (SBU) Summary: Sri Lanka?s newly elected President presented the revised 2006 budget to Parliament on November 8. In keeping with the President?s election manifesto, the budget contained a series of ?pro-poor? welfare measures and a significant salary hike to government servants. The budget also aims to increase public investment spending. The budget is not private sector friendly and increases the tax burden on corporations in particular. The welfare focus of the budget and lack of focus on economic growth oriented policies are key worries. Increased welfare spending and the 9.1 percent deficit will likely fuel inflation next year. End Summary

¶2. (U) On December 8, newly elected Sri Lankan President Mahinda Rajapakse presented the revised 2006 Government of Sri Lanka budget in Parliament. The budget aims to fund election promises and contains a range of welfare measures and tax proposals. Soon after coming into power in mid-November, Rajapakse, who is also the Finance Minister, canceled the 2006 budget presented by former-Finance Minister Sarath Amunugama under President Kumaranatunga?s administration (Ref A).

Mahinda?s Thoughts

¶3. (SBU) In his budget speech, the President said that his ?Mahinda Chintana? (Mahinda?s thoughts) election manifesto (ref b) will form the basis for the development programs for the next six years. He expressed commitment to a ?sequenced? implementation of programs which could indicate a lack of sufficient funding or even plans to eventually abandon some of them. His comments about needing to move from pure economic theory and re-engineer the economy to create opportunities for the poor highlight a continued focus on government-driven, statist economic and social policies. Statements such as ?we must accept that many countries are reshaping their economic policies to empower themselves through home grown policies? call into question the GSL?s commitment to attracting foreign investment and may be indicative of the Marxist/Nationalist Janatha Vimukthi Peramuna (JVP) party?s influence on policy making. In another JVP-induced statement, the President also revealed plans to present a new national development strategy in the next six months, taking into account diverse views expressed on the national economy. There was no mention of the peace process in the budget speech though the budget appears to be woven around an assumption of the continuation of peace.

¶4. (U) Nivaad Cabral, the Economic Advisor to the President, speaking recently at a post-budget American Chamber of Commerce Sri Lanka (Amcham) event said that given the disparities in income distribution, the government is serious about social equity and the budget is based on this premise. He said the government was serious about attracting foreign investment while simultaneously promoting Sri Lankan business and entrepreneur-friendly policies.

Economic Growth

¶5. (U) The government expects a GDP growth rate of 6.9 percent in 2006. Inflation is projected to be around 8 percent. Money supply growth is estimated at 16 percent (Note: the GSL told the IMF it would reduce monetary supply growth to 15% (from 20%) in early 2005 - a rate it never achieved. The GSL has been relying almost exclusively on open-market operation to absorb excess liquidity. End note). The public investment level is expected to rise to 30 percent of GDP from 23%. The Government expects to raise the overall

investment level to 35 percent of GDP to achieve an economic growth rate of 8 percent over the medium term. A statement issued along with budget to comply with the Fiscal Management Responsibility Act states the debt/GDP ratio of 85 percent required under the act would be achieved by end of 2008 instead of 2006 as planned. Similarly a deficit of 5 percent of GDP envisaged under the act in 2006 would be achieved in ¶2008.

Deficit Rises to 9.1 percent GDP

¶6. (U) The new budget targets a deficit of 9.1 percent of GDP. Excluding tsunami reconstruction expenditure, the deficit would be 7.3 percent of GDP (Note: The government is using figures that do not include tsunami reconstruction expenditures in its assumptions

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and economic estimates. The rest of the cable refers to the expenditure and deficits inclusive of tsunami reconstruction costs. End note). Despite initial fears of a much larger deficit, these targets are only slightly above those in Amunugama?s previously-proposed budget, which was also ?pro poor?. The deficit is, however, higher than the 2005 deficit estimated at 8.5 percent of GDP. Both expenditure and revenue are expected to be higher in 2006 than 2005. Total expenditure is estimated at 27 percent of GDP compared to 25 percent of GDP in 2005. Total revenue is projected to be 18 percent of GDP compared to 16 percent of GDP in 2005. The expenditure side of the new budget was largely a restatement of proposals in the Amunugama budget except for additional expenditure of about Rs 10 billion ($100 million) to augment funds for key welfare programs promised in the election manifesto.

¶7. (U) Government salaries, interest payments and subsidies take up about 90 percent of current expenditures. Defense expenditures, including police and national security, are estimated at about Rs 91.6 billion (USD $916 million)(about 3.4 percent of GDP) compared to Rs 76.5 billion (USD $765 million)in 2005 (3.3 percent of GDP). The budget deficit leaves a funding gap of Rs 247 billion (USD 2.47 billion). Total domestic financing is expected to be Rs 123 billion (USD $1.23 billion) (4.5 percent of GDP). The balance will come from foreign grants and loans. Tsunami-related expenditure projected at Rs 50 billion

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(USD $500 million)(1.8 percent of GDP) is to be funded mostly with foreign grants and borrowing. It is not clear if the 2006 budget targets can be met, particularly given the extreme optimism suggested by a 26 percent rise in revenue expected in 2006. Revenue rose 24 percent in 2005, due to one time effects of a range of new tax and duty measures as well as inflation.

Largest Gain To Public Sector Employees

¶8. (U) Public employees? salaries will be increased substantially on a staggered basis in 2006 and 2007. The lowest public sector salary will increase from Rs 9,350 (USD 92) per month to Rs 11,630 (USD 114) in ¶2007. The pay hike will cost an additional Rs 9.6 billion (USD 94 million) in 2006. Additional measures include:

--Pension increases for public sector retirees

--Current workers and retirees to get a cost-of-living allowance based on the consumer price index.

--10,000 new government jobs for university graduates in 2006. In 2005, the government employed an additional 42,000 graduates. (The President?s election manifesto promised that 10,000 university graduates will be hired into government service each year.)

Welfare Programs

¶9. (U) In keeping with election promises to look after the poor, a range of benefits were offered:

-- ?Samurdhi? welfare payments to increase by 50 percent.

-- community work programs and livelihood development programs to create income earning opportunities for welfare recipients (new benefits and programs will increase the cost of Samurdhi to Rs 16 billion (USD

$160 million)from about Rs 10 billion (USD $100 million)in 2005)

-- Free meals and milk to poor expectant mothers, children below 5-years and students in rural schools.

-- A skills development program to provide 50,000 jobs.

-- urban shanty dwellers and estate workers are to be given housing facilities.

Agriculture

¶10. (U) There was a series of benefits for the agriculture sector, the most well-publicized of which was the fertilizer subsidy.

-- Fertilizer to be subsidized. Paddy and vegetable farmers will get a 50 kg bag of fertilizer at Rs 350 (USD 3.50), at a total cost of Rs 8.5 billion (USD 85 million) per year.

-- producer prices of paddy and milk are to be increased.

-- banks to be mandated to provide credit to the agriculture sector.

-- the now defunct state-owned Paddy Marketing Board to be restarted to purchase and store paddy.

-- dedicated agro zones for the cultivation of tropical fruits.

-- tax benefits for agro processing and exporters.

-- import duty on milk to be gradually increased.

State-Owned Enterprises

¶11. (U) There will not be any privatization of government bodies. Instead, they will be improved through management reforms. All state-owned enterprises (SOEs) are forecast to deliver dividend income and not rely on treasury funding. (Note: In 2005 transfers from the Treasury to SOE's were Rs 20 billion (approximately USD 200 million) or 1.1 percent of GDP. Profit-making SOE's, such as the port, banks and lottery contributed approximately Rs. 6.3 billion (USD 63 million) to state coffers in 2005. End note).

Business Promotion

¶12. (U) Other industries that received assistance are fisheries, textiles, renewable energy, printing, construction and the small and medium enterprises (SME). For example:

-- construction machinery is duty free for 2 years.

-- a new bank to fund small and medium infrastructure.

-- two industrial zones for the textile industry.

-- a special IT zone in the Southern Province.

-- concessionary credit facilities for SME?s.

-- removal of VAT on computers

Fuel Subsidy Capped

¶13. (U) The budget did not contain any analysis of the impact of high fuel prices on government finances despite owing over USD $70 million (Rs 7 billion) in unpaid subsidy obligations to the Indian Oil Corporation, the private sector player in the fuel retail business. However, the President said that the fuel subsidy will be limited to Rs 3 billion (USD $30 million) in 2006 and given only to three wheelers (scooter taxis), public transport and fisheries. He said these measures would ensure that subsidies provide relief to low income groups only.

Public Investment

¶14. (U) The public investment program shows a 51 percent increase to Rs 178 billion (USD 1.8 billion) (6.6 percent of GDP) in 2006 from Rs 118 billion (USD 1.2 billion) (5.0 percent of GDP) spent in 2005. It is unlikely that the government will be able to sustain a large public investment program due to various factors including the lack of funds and tendering and implementation delays. The budget was

not explicit on public investment spending, but referred to an ambitious list of infrastructure projects including:

--power projects (hydro and coal power),

--a bunkering port in Hambantota,

--a new harbor in Colombo (Colombo South Harbor),

--a new runway at the main airport,

--a second international airport,

--tourism zones,

--several expressways, roads and railroads.

¶15. (U) Due to the aversion of the government?s political allies to privatization, it is not clear if these projects will be opened to private sector funding although during his remarks to Amcham, Cabraal said the GSL would welcome private sector collaboration in implementing these projects.

¶16. (U) There was heavy emphasis on provincial infrastructure with a pledge to develop 2000 irrigation tanks every year. In addition, 5000 kms of rural roads are to be developed as well. Furthermore, several multi-purpose irrigation projects are to be developed in the next 2 years. (Note: It is not clear whether some of the irrigation projects and roads are the ones to be funded by Millennium Challenge Corporation funds in line with the GSL?s compact proposal or whether the GSL will finance these particular projects in addition to the compact proposal. End Note.)

Policy Bodies to Remain

¶17. (U) In terms of government economic policy and management, the National Council for Economic Development (NCED), a creation of the previous government and headed by Treasury Secretary P.B. Jayasundera, which brought private and public sector experts together to plan and oversee policy implementation in over 20 important economic sectors, is to be continued. Other agencies such as the National Procurement Agency and Strategic Enterprise Management Agency, which oversee state-owned banks and utilities, are to be parts of the newly created Plan Implementation Ministry (PIM) headed by Cabral.

Tax increases

¶18. (U) On the revenue front, the budget contains ambitious revenue targets. Revenue is projected to increase 26 percent (Rs 100 billion or USD 1 billion) in 2006 to Rs 484.4 billion (USD 4.8 billion) (17.5 percent of GDP). A range of tax increases are expected to bring in Rs 25 billion (USD 250 million). While previous governments had largely followed a policy of increasing the tax base and lowering rates, both the last United People?s Freedom Alliance (UPFA) government and the new government have deviated from this policy.

-- The corporate tax rate will rise from 32.5 percent to 35 percent.

-- The highest personal tax rate will rise from 30 percent to 35 percent.
-- a stamp duty on transfer of property and assets will be reimposed.

-- Several other taxes such as the social responsibility levy, economic service charge, ports and airports levy were all increased. Excise duties on cigarettes and liquor were also increased. There were also changes to Value Added Tax (VAT) rates. In addition, upward revisions to import duty and the EDB fees are also expected to increase revenue. Tax administration is also to be improved and additional revenue expected.

Tax breaks to some

¶19. (U) There were few measures to encourage private investment. They included tax benefits to the agriculture sector, exporters of non-plantation agricultural products, domestic suppliers to the export sector, and new industries outside the western province. There were also measures to encourage the use and import of high tech machines in certain sectors. High tech machinery will also be free of import duty. Tax concessions were also given to

professionals and companies providing professional services for payment in foreign currency. Taxes on foreign nationals working in Sri Lanka were also increased. Imports and telecast of foreign films are discouraged by a new Rs 75,000 (USD $750) tax per movie or television episode, which could have a significant impact on US films and television shows aired in Sri Lanka.

Reactions of Opposition and Private Sector

¶20. (SBU) The budget received mixed reactions. The main opposition UNP termed it an ?unrealistic? budget with overestimated revenue projections and no assurances of keeping expenditure at estimated levels. The UNP criticized the budget for increasing the tax burden and fueling inflation. For these reasons the party will abstain during the vote but will not vote against the budget as it provides relief for farmers. Deva Rodrigo, head of the Ceylon Chamber of Commerce, Sri Lanka?s largest trade chamber, and a member of Sri Lanka?s monetary board, which sets interest rates and monetary policy, told newspapers he was relieved to see a ?manageable? deficit (excluding tsunami) around 7.3 percent of GDP. He said businesses were concerned about the impact of the deficit on inflation and interest rates. National Chamber of Commerce of Sri Lanka (NCCSL), another large trade chamber, in a statement praised the regional and Small and Medium-sized Enterprises(SME) focus of the budget. The Chamber said that while tax increases are negative that they recognize the need for the increase. NCCSL noted the budget is silent on many liberalization issues key to private sector development.

Comment

¶21. (SBU) While the new budget kept largely to the framework of the last Government?s submission, it was presented in a manner more reflective of the new President?s campaign platform. While its heavy emphasis on Government welfare programs, non-productivity enhancing agriculture policies (including subsidies for fertilizer) and increased government employment are worrying, its high tax rates (which have been grudgingly accepted by the business community in order to keep the deficit in check) and cap on the run away fuel subsidy are important counterweights. However, the increased corporate and personal taxation and an increased VAT on banking may discourage private sector activity.

¶22. (SBU) Comment cont.: In order to achieve an 8 percent growth rate in the medium term, the GSL will need to adopt measures that spur investment and increase productivity, but it is not clear that this budget will give an impetus to private domestic investment or attract more foreign direct investment. While some of the major infrastructure projects called for could have beneficial impacts on overall productivity, the Government?s ability to finance and implement such programs remains unproven. We will monitor with interest the GSL?s performance this budget year as well as the country?s macroeconomic performance. One potentially related area of concern, as we work with the MCC to conclude compact negotiations, will be whether this budget reflects the adoption of policies that might lead to deterioration in Sri Lanka?s MCA eligibility score. End Comment.

ENTWISTLE